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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 723

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL GROCERY COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals, together with the dissenting opinion (R. 17–32), is reported in 35 B. T. A. 163. The opinion of the Circuit Court of Appeals for the Third Circuit (R. 172–180) is reported in 92 F. (2d) 931.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 21, 1937 (R. 180). The petition for certiorari was filed January 20, 1938, and was granted February 28, 1938. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the court below departed from the accepted and usual course of judicial proceedings in its decision and opinion concluding that there was no evidence to sustain the determination of the Board of Tax Appeals that respondent was availed of during the taxable year for the purpose of preventing the imposition of the surtax upon its sole stockholder.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 28–32.

STATEMENT

The Commissioner determined that in the taxable year ended January 31, 1931, the respondent had permitted its profits to accumulate beyond the reasonable needs of its business instead of being distributed, which he construed as prima facie evidence of the purpose to prevent the imposition of the surtax upon its stockholder, and accordingly determined a deficiency in the amount of $477,360.68 (R. 14).

The Board sustained this determination (R. 33). In its opinion the Board stated that it concluded from the evidence before it (1) that the respondent's accumulations of earnings in the taxable year were far in excess of the reasonable needs of the corporate business (R. 22–23); (2) that the evidence did not overcome the resultant statutory pre-

sumption; and (3) that the respondent was availed of for the interdicted purpose during the fiscal year ended January 31, 1931 (R. 24).

The findings of the Board may be summarized as follows (R. 18–21):

Since 1908 the respondent corporation, all of whose shares were beneficially owned by its organizer, one Kohl, had operated a chain of grocery stores on a "cash and carry" basis. Its annual profits in the fiscal years ended January 31, 1923, to January 31, 1931, had been in excess of $500,000, and for the last four of these $818,043.54, $870,-144.92, $806,507.32, and $786,466.98, respectively; in these years it had operated 715, 782, 799, and 815 stores, respectively. In the same period it had paid Kohl a salary of $2,000 a week (R. 18). For a long time the respondent had invested its surplus profits in stocks and bonds in order to obtain a greater return therefrom than would have been possible from bank deposits and with the thought in mind of realizing cash thereon for the purpose of expanding its chain of grocery stores at any time desired. The only dividends it had paid up to the end of the taxable year were two of $25,000 each, one in 1917 and one in 1918. On the other hand, the respondent had advanced $394,100 to Kohl up to January 26, 1925, on notes bearing interest, although no interest had ever been charged or paid thereon; and thereafter it made further loans to him on notes bearing no interest, so that at the end of the taxable year it had loaned him $610,000.

In that year the respondent loaned Kohl $140,000, of which $40,000 was to enable him to acquire a house in Florida, and $100,000 to make a personal charitable contribution. A part of the loans was canceled in subsequent years by dividends declared after the end of the taxable year, a balance of $424,000 remaining unpaid as late as April 23, 1936 (R. 19–20). The respondent's balance sheet for the fiscal years ended January 31, 1928, to January 31, 1931, inclusive, shows as follows (R. 20):[1]

	Fiscal years ended			
	1/31/28	1/31/29	1/31/30	1/31/31
ASSETS				
Cash	$659,734.40	$890,397.59	$1,332,332.28	$1,405,961.04
Notes receivable	424,100.00	460,000.00	470,000.00	610,000.00
Accounts receivable	1,888.82	3,975.19	26,816.37	3,220.85
Inventories	2,615,057.67	2,917,716.55	3,189,396.72	2,812,939.16
Mortgage	59,000.00	59,000.00	59,000.00	59,000.00
Bonds	256,114.76	96,820.30	59,435.00	313,391.27
Stocks	2,169,687.62	2,318,074.13	2,720,283.07	2,676,061.47
Other	6,236.39	7,425.08	10,150.89	20,686.18
Deferred	33,338.64	25,685.23	31,875.79	29,687.74
Permanent	1,542,129.60	1,501,193.83	1,345,976.63	1,177,489.43
Total	7,767,287.90	8,280,287.90	9,245,266.75	9,108,437.14
LIABILITIES				
Notes payable and mortgages	1,008,750.00	700,000.00	790,000.00	----------
Accounts payable	258,889,61	270,318.54	371,121.96	269,140.49
Accrued	7,742.15	7,385.56	19,757.11	7,411.70
Reserve income tax	93,933.45	72,035.56	52,592.97	51,330.42
Reserve insurance	417,797.77	491,032.34	565,970.45	641,588.99
Capital stock and surplus	5,980,174.92	6,739,515.90	7,445,824.26	8,138,965.54
Total	7,767,287.90	8,280,287.90	9,245,266.75	9,108,437.14

The fair market value of the securities owned by the respondent on January 31, 1931, was $2,125,-

[1] The tabulation is a part of the respondent's balance sheet, 1907 to 1935 (Exhibit 6, R. 136X137).

434.50, as against the cost of $2,989,452.74, a difference of $864,018.24.

In conclusion, the Board found that, during the fiscal year ended January 31, 1931, the respondent was availed of for the interdicted purpose.

The court below, in an opinion written by Judge Buffington, Judge Biggs dissenting, reversed the Board's decision, on the ground that the Board had relied solely on the report of a revenue agent and other information furnished to the Commissioner; that it had failed to pass on what the court considered the uncontradicted proof of the respondent; and that this assertedly uncontradicted testimony showed that the business needed the surplus which respondent maintained (R. 172–180). "Without entering into further details," the court below held that "the Tax Board had before it no proof, substantial or otherwise, to support its imposition of this penal tax" (R. 178).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred—

1. In finding, concluding, and holding that the Board of Tax Appeals had failed to pass upon what the court considered to be the uncontradicted proofs made by the respondent, and that, when this was called to the Board's attention, it had failed to call witnesses but had based its finding solely upon a report made to the Commissioner by a revenue agent of an *ex parte* investigation made by him, which is not in evidence, and upon certain subse-

quent information furnished the Commissioner, the nature of which is not disclosed by the evidence.

2. In failing to remand the proceeding to the Board for a rehearing, if it is true that the Board was guilty of such an arbitrary disposition of the issues.

3. In usurping the power of administrative decision by finding the facts from conflicting evidence, determining the issue itself, and substituting such determination for that of the administrative body.

4. In rejecting a finding of fact made by the Board that, in the fiscal year ended January 31, 1931, the respondent's gains and profits were permitted to accumulate beyond the reasonable needs of its business, where it does not appear that the evidence, with every reasonable inference that may be drawn therefrom in the petitioner's favor, is insufficient to sustain such finding, and in making its own contrary finding upon the basis of testimony of certain facts which, standing alone, would support such contrary finding; and, in so doing, failing to consider evidence of an array of facts, which, together with proper inferences to be drawn therefrom, discounts the testimony which the court relied upon and supports the finding of the Board.

5. In rejecting a finding of fact made by the Board that the respondent has failed to overcome the statutory presumption arising from the fact that it had permitted its gains and profits to accumulate beyond the reasonable needs of its busi-

ness, where it does not appear that the evidence, with every reasonable inference that may be drawn therefrom in favor of the petitioner, is insufficient to sustain such finding.

6. In rejecting a finding of fact made by the Board that the respondent was availed of for the interdicted purpose, where it does not appear that the evidence, with every reasonable inference that may be drawn therefrom in the petitioner's favor, is insufficient to sustain it.

7. In entering a judgment the effect of which is either to expunge the deficiency determined by the Board or to require the Board to do so.

8. In reversing the Board's order of redetermination of the deficiency in the tax of $477,360.68.

SUMMARY OF ARGUMENT

Section 104 of the Revenue Act of 1928 imposes an additional tax of 50 per cent upon corporations formed or availed of for the purpose of permitting its shareholders to escape surtaxes, and makes the accumulation of earnings and profits beyond the reasonable needs of the business prima facie evidence of such purpose. From the evidence before it the Board found that the respondent's accumulations in the taxable year ended January 31, 1931, were beyond such needs; that the evidence did not overcome the attendant presumption, and that the corporation was availed of in that year for the interdicted purpose.

Instead of reviewing all of the evidence to determine whether, with inferences favorable to the

petitioner, it supported the Board's decision, the court below proceeded first to a destructive analysis of the Board's decision and then to an independent determination of the issue. In both respects it committed reversible error.

The error involved in the analysis of the Board's decision is important because it is in large part due thereto that the court below disregarded its true basis. It is abundantly clear that, while the Board may have arranged its opinion "inartistically" (cf. R. 180), it did determine for itself as a fact and upon the evidence before it, that the gains and profits had been accumulated beyond reasonable business needs; and that it then determined from all the evidence that the attendant presumption had not been refuted and that the corporation was availed of for the interdicted purpose.

In proceeding itself to find the facts from conflicting evidence, contrary to the findings of the Board, the court below culled from the evidence certain facts which, standing alone, would have supported a contrary finding. In so doing, the court failed to consider an array of facts which not only discounted the testimony the court relied upon but amply justified the Board's findings. The facts ignored in the majority opinion below clearly indicate that a sizable portion of the respondent's profits for the taxable year in question could have been declared as dividends without curbing in the

slightest the reasonable needs of its business. Furthermore, these facts effectively dispose of the various reasons given by the respondent in support of its contention that it did not entertain such purpose.

The respondent's sole stockholder, Kohl, used it as his "pocketbook." The evidence clearly indicates that disbursements were made to him upon the basis of his own needs and not upon the basis of what the respondent could reasonably have disbursed to him.

The conclusion is inescapable that, in its review of the Board's decision, the court below has departed from the usual and accepted course of judicial proceedings, and that the Board's decision should have been affirmed because it was supported by the evidence.

ARGUMENT

THE COURT BELOW DEPARTED FROM THE ACCEPTED AND NORMAL COURSE OF JUDICIAL PROCEEDINGS IN ITS DECISION AND OPINION CONCLUDING THAT THERE WAS NO EVIDENCE TO SUSTAIN THE DETERMINATION OF THE BOARD OF TAX APPEALS THAT THE RESPONDENT WAS AVAILED OF DURING THE TAXABLE YEAR FOR THE PURPOSE OF DETERMINING THE IMPOSITION OF THE TAX

(a) *The question before the court below and how it arose*

Subdivision (a) of Section 104 of the Revenue Act of 1928 (Appendix, *infra*, p. 28) imposes an additional tax of 50 per cent of net income upon

any corporation that is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed. Article 541 of Treasury Regulations 74, promulgated under that Act (Appendix, *infra*, p. 29), explains that the section was designed to discourage the formation or use of a corporation for the interdicted purpose.[2] Subdivision (b) of said section (Appendix, *infra*, p. 28) provides that the fact that any corporation is a mere holding or investment company, or that its gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the

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[2] See also S. Rep. No. 617, 65th Cong., 3d Sess., p. 5; S. Rep. No. 275, 67th Cong., 1st Sess., pp. 16–17; *A. D. Saenger, Inc.* v. *Commissioner*, 84 F. (2d) 23, 24 (C. C. A. 5th), certiorari denied, 299 U. S. 577. The statute is designed reasonably to carry out the purpose of Congress to prevent tax avoidance. *Almours Securities* v. *Commissioner*, 91 F. (2d) 427, 429 (C. C. A. 5th), certiorari denied January 10, 1938; *Williams Inv. Co.* v. *United States*, 3 F. Supp. 225, 232 (C. Cls.). Compare *Helvering* v. *Mitchell*, No. 324, October Term, 1937, decided March 7, 1938, and particularly note 15 to the opinion of the Court. As such, it must be reasonably construed to effectuate such purpose. *Taylor et al* v. *United States*, 3 How. 197; *United States* v. *Stowell*, 133 U. S. 1; *United States* v. *Hodson*, 10 Wall. 395; *United States* v. *Graf Distilling Co.*, 208 U. S. 198; *Farmers' Loan & Trust Co.* v. *Bowers*, 68 F. (2d) 916 (C. C. A. 2d), certiorari denied, 293 U. S. 565, 296 U. S. 649, and 299 U. S. 582.

tax;[3] and Article 543 declares the accumulation to be unreasonable "if it is not required for the purposes of the business, *considering all the circumstances of the case.*" [Italics supplied.]

The Board found, upon the evidence adduced, that the respondent's "accumulation of earnings was far in excess of the 'reasonable needs' of the corporate business;" furthermore, that the evidence did not rebut the prima facie presumption created by the statute that the accumulation of earnings beyond the "reasonable needs of the business" was for the purpose of preventing the imposition of the surtax upon its sole stockholder (R. 23); and that upon the evidence before it, the Board had made the finding (R. 21) that the respondent was "availed of" for the interdicted purpose, during the fiscal year ended January 31, 1931. Whether the respondent permitted its gains and profits to accumulate beyond the reasonable needs of its business, and whether it was availed of for the purpose of preventing the imposition of a surtax upon its shareholders are clearly questions of fact, upon which the Board's findings are conclusive if sup-

[3] As the Circuit Court of Appeals for the Second Circuit pointed out in *United Business Corporation* v. *Commissioner*, 62 F. (2d) 754, 755, certiorari denied, 290 U. S. 635, the presumption is necessary as the purpose is difficult of establishment, unless the officers of the corporation unexpectedly disclose a scheme to avoid taxes. As Judge Learned Hand in that case said the corporation is thereby compelled to show its hand in circumstances justifying the presumption.

ported by the evidence. *United Business Corporation* v. *Commissioner,* 62 F. (2d) 754 (C. C. A. 2d), certiorari denied, 290 U. S. 635; *United States* v. *R. C. Tway Coal Sales Co.,* 75 F. (2d) 336 (C. C. A. 6th); *A. D. Saenger, Inc.,* v. *Commissioner,* 84 F. (2d) 23 (C. C. A. 5th); certiorari denied, 299 U. S. 577; *R. & L., Inc.,* v. *Commissioner,* 84 F. (2d) 721 (C. C. A. 5th); *Commissioner* v. *Fisher & Fisher,* 84 F. (2d) 996 (C. C. A. 2d); *Commissioner* v. *Cecil B. De Mille Productions,* 90 F. (2d) 12 (C. C. A. 9th), certiorari denied, October 11, 1937; *Almours Securities* v. *Commissioner,* 91 F. (2d) 427 (C. C. A. 5th), certiorari denied, January 10, 1938. Thus the only question before the court below was whether the evidence, with every reasonable inference to be drawn therefrom in the petitioner's favor, supported the findings and judgment of the Board.

(b) *The disposition of the question by the court below*

What the court below should in these circumstances have done, but did not do, was to review all of the evidence in the case to determine whether there was any evidence to support the Board's findings and decision. Instead, it proceeded first to a destructive analysis of the Board's decision and then to an independent determination of the issue. In both respects, we think, the court committed error.

Specifically, with respect to its analysis of the Board's decision, the court wrongfully charged the

Board with having neglected to consider what the court regarded as the uncontradicted proofs given by the respondent;[4] with having based its action solely on the revenue agent's report and other information furnished to the Commissioner, none of which was in evidence; with having failed itself to determine whether the profits were accumulated beyond the reasonable needs of the business, or to make a finding to that effect;[5] with having failed

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[4] It cannot be said that the evidence recited by the court was truly uncontradicted. While the Government did not introduce opposing opinion evidence, this was not necessary. The respondent's evidence carried its own refutation; it supported the affirmative. Besides, the development in the record of the actual status of respondent's business consists largely of joint exhibits. Several of the exhibits formally introduced by respondent were prepared by the Government (R. 56) and were offered at the Government's request (R. 57, 59) or with its prior approval (R. 48, 53, 56) and in a joint effort to facilitate the conduct of the trial.

[5] Since the court stated that the "basic thing was for the Board to itself determine whether the 'profits are permitted to accumulate beyond the reasonable needs of the business,'" and then observed that "the Board made no such finding as the Act requires" (R. 177), apparently the court felt that the finding omitted by the Board was that pertaining to accumulation beyond the reasonable needs of the business. But the court then stated that the Board had failed to make the required finding "notwithstanding its attention was called thereto in the dissenting opinion" (R. 177). Examination of the paragraph quoted from Member Mellott's dissent (R. 25) discloses that he had reference to the finding of the ultimate purpose to escape surtaxes rather than the intermediate fact of accumulation beyond the reasonable needs of the business. Moreover, he was merely calling attention to the Commissioner's failure explicitly to make this finding, and by no means implied that the Board did not make such a finding.

to made the finding required by the statute, though the dissenting members called attention to this, and instead construing the revenue agent's report and the other information furnished the Commissioner as *prima facie* evidence of a purpose to prevent the imposition of a surtax upon respondent's stockholder; and with acting on this allegedly foundationless *prima facies* in drawing the conclusion that "We [the Board] are also of the opinion that the evidence of record does not rebut the prima facie presumption created by the statute" (R. 23). The error involved in this analysis is important because it was in large part due thereto that the court below disregarded the true basis of the Board's decision and much of the evidence introduced before it and considered by it.

Now, if it had been true that the Board was guilty of such an arbitrary disposition of the issues, it was clearly the duty of the court to remand the proceeding for rehearing, so that the Board could consider the evidence it had allegedly neglected to consider on the first hearing. But, instead, and while ostensibly reviewing the facts to determine whether there was any evidence to sustain the Board's findings of an accumulation beyond the reasonable needs of the business and of the interdicted purpose, the court below proceeded itself to

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But, whichever finding it was that the court thought had not been made by the Board, it is apparent that it made both findings upon its own inferences from evidence introduced before it. See *infra*, pp. 16–18.

find the facts from conflicting testimony and to determine the issues contrary to the findings of the Board. Moreover, in so doing, it culled from the evidence certain facts, which, standing alone, would support such a contrary finding. Thus it dwelt at great length upon the history of the respondent's "cash and carry" business, as testified to by Kohl, and his testimony and that of other witnesses called by the taxpayer to the effect that in their opinion the accumulations were reasonably necessary (1) in the expansion of its grocery business, (2) in the conduct of that business, and (3) because of the depreciation in the value of its investments during the depression. And, by the same token, it failed to consider an array of facts (see *infra*, pp. 18 to 25), which, together with inferences to be drawn therefrom, not only discounted the testimony the court relied upon, but amply justified the findings of the Board. In short, the court below proceeded with the case as though the findings and decision had been in the *respondent's* favor, selecting from the evidence and discussing such facts as would have supported such a judgment.

The signal objection to such review is that the court thereby disposed of the case in accordance with its own inferences from the evidence. It tried the case *de novo,* substituting its own judgment for that of the administrative body and thus usurped the power of administrative decision. It is only the trier of the facts who may choose between con-

flicting inferences which arise from the facts. "It is the function of the Board to weigh the evidence and declare the result." *Elmhurst Cemetery Co.* v. *Commissioner,* 300 U. S. 37, 40. Clearly the court below has disregarded the injunction in *Hulburd* v. *Commissioner,* 296 U. S. 300, 306, that it is "without power to choose between conflicting inferences unless only one was possible, or to try the case *de novo.*" Compare *Helvering* v. *Rankin,* 295 U. S. 123.

In fact, however, the court below misinterpreted the basis of the Board's decision.

(c) *The actual basis of the Board's decision*

Although the Board did set out so much of the Commissioner's deficiency letter as gave his reasons for his determination—namely, that, upon the basis of information furnished that office he had approved the conclusion of the revenue agent that there existed an accumulation of profits beyond the reasonable needs of the business—the Board nowhere indicated that it was relying on the Commissioner's finding, or on the revenue agent's report, or on the other information furnished the Bureau therein referred to; and it certainly negatived any suggestion that the deficiency letter, or the evidentiary matter therein mentioned, constituted the basis of its decision. It is abundantly clear that, though the Board may have arranged its opinion "inartistically" (Cf. R. 180), it did determine for itself and find as a fact, and upon the evi-

dence before it, that the gains and profits had been accumulated beyond the reasonable business needs (R. 22–23), and that it then examined the other evidence and from all the evidence determined that the statutory presumption of the purpose to avoid surtaxes had not been rebutted—indeed that it had been corroborated (R. 23–24)—concluding with an express finding of the interdicted purpose (R. 24).

The Board concisely summed up the evidence on which it primarily relied in reaching its conclusion that the accumulation of profits was beyond the reasonable needs of the business. It adverted to several factors in the evidence—namely, (a) that since prior to 1922, when the respondent began to invest in stocks and bonds, its holdings of securities had greatly increased, and that up to 1929 there had also been a very large increase in the market value of the securities acquired; (b) that, since 1929, the respondent had not greatly expanded its grocery business; (c) that its large profits had not been distributed as dividends but had been mostly invested in securities; (d) that the respondent's balance sheets for the beginning and the end of the taxable year showed current assets far in excess of actual liabilities, cash on hand alone being far in excess of actual liabilities; and (e) that its actual surplus at January 31, 1931, was $7,938,965.54. And, finally, the Board disposed of the taxpayer's contention that the surplus was of benefit to it in obtaining credit at banks and in enabling it to purchase merchandise at low prices and

in obtaining lower rates of interest because of its large investment in stocks and bonds (R. 22–23).

Only then did the Board turn to a consideration of whether the evidence rebutted the statutory presumption attending its finding that the accumulations were beyond the respondent's reasonable business needs. The Board, concluding that it did not, pointed out that the evidence showed that Kohl personally needed some of the profits in that year, had prior thereto borrowed $470,000 from the company without paying interest, and had increased his borrowings by an additional $140,000 in the taxable year with the result that there was an escape of the surtax upon (at least) that amount (R. 23–24).

(d) *The facts which the court below overlooked or disregarded*

In addition to its disregard of the Board's findings, the court overlooked or disregarded an array of facts and circumstances which, together with proper inferences to be drawn therefrom, not only discount the testimony it relied upon, but amply justify the findings of the Board.

Respondent's profits for the taxable year were shown on its books (after deducting Kohl's salary of $104,000 and its income taxes of $103,616.60) as $682,550.38.[6] The facts about to be discussed in-

[6] The net taxable income, upon which the tax was based, as shown in Exhibit A, attached to the respondent's petition filed with the Board, was $954,645.62. The correctness of

dicate clearly that a sizeable portion of this profit could have been declared as dividends without curbing in the slightest the reasonable needs of the business. Furthermore, the facts effectively dispose of each of the reasons given by the respondent in support of its contention that it did not entertain the purpose to avoid surtaxes, namely, (1) that it needed the accumulations to acquire new stores; (2) that it needed them in its grocery business; and (3) that they were needed because of the depreciation in the value of its securities and other property.

(1) The accumulations were not needed to acquire new stores. Respondent's policy was merely to rent stores, not to purchase the real estate on which they were located (R. 68). Only $5,000 was needed to acquire and finance each new store (R. 68–69). During the taxable year respondent paid off all its bank loans, $790,000, and decreased its accounts payable by more than $100,000 and its accrued expenses by more than $12,000 (Exhibit 6, R. 136–137). Yet it had left a working capital of $4,500,000, according to its witness, Field (R. 86); and, though his mode of estimate is not set out, his

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this figure is not in controversy. The Board, in its finding (R. 18), used the book figure of $786,466.98, which was apparently derived from the books, and may represent a slight arithmetical error of $300 in adding $682,550.38 and $103,616.60, the correct sum of which is $786,166.98.

figure is, if erroneous at all, too small.[7] Since respondent had $1,405,961.04 cash in the bank, and current liabilities of only $276,552.19 (R. 137), it is obvious that it could have paid its current liabilities

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[7] Field stated that the working capital at the end of 1930 was $3,700,000-odd, and at the end of January 1931 was $4,500,000 (R. 86).

The normal signification of "net working capital" is the excess of current assets over current liabilities. Paton, *Accountants' Handbook* (2d Ed., 1934), pp. 19, 153; Kester, *Principles of Accounting* (3d Revised Ed.), Vol. 1, p. 29. "Current assets" include cash and other assets, such as accounts receivable and inventory which will presumably be converted into cash in the near future through the regular operations of the business. Finney, *Introduction to Principles of Accounting* (1932), p. 167; Kester, *Principles of Accounting*, *supra*, pp. 28–29.

The following computation of working capital is based on Exhibit 6, R. 137:

	Year ending	
	1/31/30	1/31/31
Current Assets:		
Cash	$1,332,332.28	$1,405,961.04
Notes Receivable	470,000.00	610,000.00
Accounts Receivable	26,816.37	3,220.85
Merchandise Inventory	3,189,396.72	2,812,939.16
Mortgage	59,000.00	59,000.00
Bonds and stocks	2,779,718.07	2,989,452.74
Total current assets	7,857,263.44	7,880,573.79
Current Liabilities:		
Notes Payable	750,000.00	
Accounts Payable	371,121.96	269,140.49
Accrued Expenses	59,757.11	7,411.70
Total current liabilities	1,180,879.07	276,552.19
Working capital	6,676,384.37	7,604,021.60

Even if account is taken of the depreciation in the value of the stocks and bonds, and their book value is replaced by

in full in cash, could in addition have acquired and financed 100 additional stores with cash, and still have had left a working capital of at least $3,723,447.81, of which $629,408.85 would have been in cash.

(2) The accumulations were not needed in the respondent's grocery business. The testimony considered by the court with respect to this point is even more vague than the testimony regarding expansion. The court (R. 175) quoted Mr. Field's references to "panicky conditions," to the company's turnover, to the necessity for "a considerable working capital and a surplus to meet any additional losses they might encounter" (apparently on inventory).[8]

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fair market value (which, according to respondent's own estimate (R. 61–62, 146), was $2,859,217.25 as of January 31, 1930, and $2,125,434.50 as of January 31, 1931), the working capital is still seen to be $6,755,883.55 on January 31, 1930, and $6,740,003.86 on January 31, 1931, much higher than Field's figures.

Field may have obtained these figures by eliminating all consideration of stocks, bonds, and mortgages, for, upon that hypothesis, the working capital figures become $3,837,666.30 on January 31, 1930, and $4,555,568.86 as of January 31, 1931. There seems to be no warrant, however, for excluding from "current assets" an item of investments which respondent claims to have acquired merely in order to have on hand an equivalent of cash.

[8] It is true that Kohl (R. 72), as well as Miss Mullins, the treasurer (R. 79), testified that the accumulations were needed to finance purchases, pay rent, etc., and that at times the company was forced to borrow money to do so. But neither gave any further particulars, and it is not to be assumed that the corporation needed its $8,000,000 accumula-

In discussing respondent's working capital needs, it may first be noted that its "cash and carry" system rendered unnecessary as large a working capital as would be needed by a concern extending credit. Thus, the apparently formidable item of respondent's purchases, amounting to about $20,000,000 for the year in question (R. 141), must be considered in light of the fact that respondent turned its stock over *on a cash basis* from 6 to 8 times a year (R. 86). In this way, it received some $25,000,000 from its merchandise sales (R. 7).

It is apparent that respondent's working capital far exceeded its reasonable needs. Field's minimum estimate of respondent's working capital of January 31, 1931, as $4,500,000 (which at least takes into consideration depreciation of both merchandise[9] and securities, if it does not actually

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tion for these purposes, or that the shortage in cash did not occur because at the time the cash normally available for these purposes had been or was being used in the purchase of securities. In the circumstances, the purport and effect of this testimony was for the trier of the fact.

[9] The difference between inventory for January 31, 1930, and January 31, 1931, cannot be regarded as depreciation. Kohl testified that everything declined in value in 1930 and the petitioner's witness, Anna Mullins, the treasurer of the company, testified that there was a "decline" in the petitioner's merchandise inventories from $200,000 to $250,000. If we consider the fact that there was a complete turnover in its capital 6 or 8 times in that year, involving purchases of merchandise in excess of $19,000,000, the inference seems inescapable that much of the decline referred to resulted from new purchases in the course of the year at lower prices rather than from a decline in the value of goods that had been purchased in prior years at higher prices.

eliminate them entirely, see *supra*, note 7) bears a ratio to current liabilities of 15 to 1, while the ratio of cash to such liabilities was 5 to 1. As to Field's fears with respect to additional losses on inventory, if the merchandise had declined in value by half—some $1,400,000—working capital would still have been more than ten times as large as current liabilities.

The court below did not rest content with the explanations of respondent's witnesses. It added a word of its own and regarded the accumulations as respondent's bulwark against fires, earthquakes, floods, war, strikes, boycotts, and a host of unforeseen calamities. None of the witnesses stated that the profits were accumulated for these purposes, and none of them even suggested that earthquakes, floods, etc., were probable in New Jersey, or expensive to insure against, or that in 1930 the respondent's labor relations were unsatisfactory. Indeed, with respect to the only fears that the company deemed real and reasonable (fire, burglary, etc.), it had started its own self-insurance reserves (R. 60, 144), which it carried as a liability on its balance sheets (R. 137).

(3) The accumulations were not needed because of the depreciation in value of the securities or inventories. Computations with respect to working capital making allowance for depreciation still

show an unreasonable accumulation.[10] See pp. 19–23, and note 7, *supra*.

Moreover, on cross-examination, both Kohl and the company treasurer explicitly testified that neither an increase nor decrease of the petitioner's assets had anything to do, practically speaking, with the declaration of dividends (R. 74, 83, 84). Mr. Field and Mr. Ferguson, bankers called as witnesses by respondent, both testified that the company could have declared a dividend in 1930 of

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[10] The respondent offered Exhibit 15 (R. 146) for the purpose of showing depreciation in the market value of its securities as of January 31, 1931, to be $943,517.42 (R. 61–62). Nevertheless, in the court below, as also in its brief in opposition (pp. 7–8), it argued that to this should be added the sum of $1,068,622, representing the market value of six bank stocks as shown on Exhibit 15, for which the witness Field said there was, in fact, no sale. Thus respondent seeks to draw inferences favorable to it even upon contradictory evidence introduced by it. Furthermore, with respect to one of the items sought to be eliminated, namely, $38,600, the market value of the stock of the First National Bank of Jersey City, it is to be noted that 300 shares of this were purchased by it in the taxable year in question for $23,400. (See the fourth sheet of said Exhibit 15, 3rd item in column headed "Purchases after 1/31/30.")

It is further to be noted that the respondent also contended that there should be added $376,457.56, which represents merely the difference between the opening and closing inventories for the year in question. Clearly there is no justification for that. Furthermore, since these inventories were taken at cost or market, whichever was lower, the closing inventory already reflected any loss in value that the goods inventoried may have sustained at the end of the taxable period. (See Exhibit 6, R. 136; also note 9, p. 22, *supra*.)

$100,000, without impairing its business (R. 90, 94). Indeed Field testified (R. 90) that respondent's credit was "as good today as it was ten years ago" though in the five years subsequent to the taxable year in question the petitioner had paid $800,000 in dividends out of a much diminished net profit of $1,341,382.42 (R. 133).[11]

(e) *The climactic fact that the sole stockholder used the respondent corporation as his "pocketbook"*

The facts discussed above support, we submit, if indeed they do not compel, the finding that the gains and profits of respondent were permitted to accumulate beyond the reasonable needs of the business. That the purpose of this accumulation was the avoidance of surtaxes on the sole stockholder, Kohl, is borne out by the fact that Kohl used the corporation as his "pocketbook."

[11] See the following table derived from Exhibit 4 (R. 133):

Year ending January 31	Net profits after deducting Kohl's salary & Inc. taxes	Dividends declared	Left for accumulation
1931—1/31/32	$525,947.67	$100,000.00	$425,947.67
1932—1/31/33	132,991.35	100,000.00	32,991.35
1933—1/31/34	111,211.91	100,000.00	11,211.91
1934—1/31/35	368,685.50	300,000.00	68,685.50
1935—1/31/36	202,545.99	200,000.00	2,545.99
Total	1,341,382.42	800,000.00	541,382.42

The only dividends paid to Kohl by respondent up to January 31, 1931, were a dividend of $25,000 in 1917, and one of a like amount in 1918 (R. 19, 84; Ex. 4, R. 133). Kohl followed the policy of "keeping all of my profits in the business, except what were necessary for my bare living expenses" (R. 66). But by January 31, 1930, he had borrowed from respondent $470,000, partly on demand notes bearing no interest and partly on notes on which no interest has ever been charged or paid (R. 19). During the taxable year it loaned him an additional $140,000, on notes bearing no interest, in order that he might acquire a house in Florida and make a charitable contribution (R. 20, 24). These loans, taken together with the fact that since 1925 respondent has paid Kohl a salary of over $100,000 a year, deductible on its income tax return, indicate that disbursements were made to him upon the basis of his needs and not upon the basis of what the respondent could reasonably have disbursed (cf. R. 66).

CONCLUSION

The conclusion appears inescapable that in its review and consequent reversal of the decision of the Board in this case, the court below has departed from the accepted and usual course of judicial proceedings. And, since the Board's findings and decision are supported by evidence, it is respectfully

submitted that the judgment of the court below should be reversed with direction to dismiss the respondent's petition for review.

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MARCH 1938.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner, and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their

returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 541. *Taxation of corporation utilized for evasion of surtax.*—Section 104 is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon its shareholders, through the device of permitting its gains and profits to accumulate instead of being distributed. If a domestic or foreign corporation is so formed or availed of, it is subject to a tax at the rate of 50 per cent upon its net income in addition to the tax imposed by section 13. However, the additional tax at the rate of 50 per cent does not apply for 1928 or any subsequent taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year or years. Any amount so included in the gross income of a shareholder shall be treated as a dividend received, and any subsequent distribution made by the corporation out of the earnings or profits for such taxable years shall, if distributed to any shareholder who has so included in his gross

income his distributive share, be exempt from tax in the amount of the share so included.

ART. 542. *Purpose to escape surtax.*—Prima facie evidence of a purpose to escape the surtax exists where a corporation is a mere investment company, where a corporation has practically no business except holding stocks, securities, or other property and collecting the income therefrom or investing therein, or where a corporation other than a mere holding or investment company permits its gains and profits to accumulate beyond the reasonable needs of the business. The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 104 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the

second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business.

ART. 543. *Unreasonable accumulation of profits.*—An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Distributions made by a corporation shortly after the close of its taxable year shall be taken into consideration in determining the reasonableness of the amount of earnings and profits of the corporation retained by it for such year. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money,

using capital, surplus, and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. It is an unreasonable accumulation of gains and profits by corporations with the purpose of enabling their shareholders to escape surtaxes on such gains and profits which subjects such corporations to the additional tax imposed by section 104. Among other things, the financial condition of the corporation at the close of the taxable year and the manner in which its funds are invested at that date, determine the reasonableness of the accumulations.

For the purpose of section 104 the term "net income" means the net income of the corporation as defined in section 21 increased by the sum of (1) the amount received as dividends and allowed as a deduction by section 23 (p), plus (2) the amount of interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner. The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by, each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 149 (c).)

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